AUDIT REPORT – COUNTY INVESTMENTS

Final Report – October 30, 2015 from the New Castle County Auditor's Office

<u>Audit Report – County Investments</u>

To: Thomas Gordon, County Executive
David Grimaldi, Chief Administrative Officer
Michael Coupe, Chief Financial Officer

Opinion

In our opinion, internal controls over County investments need improvement in the following areas:

- Development of an investment policy which is properly authorized by the County Executive. **See Comment #1 on page 10.**
- Periodic assessment of risk tolerance of investment portfolio(s) and understanding of such among key parties, including County Council. **See General Comment on page 6.**
- Monitoring of County investment managers to ensure compliance with County investment policy. **See Comment #'s 2 and 3 beginning on page 11.**
- Procurement of outside investment managers in a manner which complies with County Code. **See Comment #6 on page 27.**
- Review of contracts for investment managers. **See Comment #'s 7 and 8 beginning on page 30.**
- Transparency to County Council and to the public on various aspects of the investment process, including investment performance. **See General Comment on page 9 and Comment # 13 on page 44.**
- Ensuring County reserve funds are easily ascertainable and withdrawals from such funds are properly authorized. **See Comment #9 on page 34.**

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We strongly believe County Council should create an Investment Board to oversee the County's investment portfolio, particularly the County's reserve funds. **See Comment #11 on page 42.**

Overview

New Castle County (NCC) Code Section 2.05.503 states "The Office of Finance, managed by the Chief Financial Officer … may perform the following functions …

G. Maintain the treasury of the County, and deposit the moneys belonging thereto or in the custody thereof in any depository bank, to the credit of the County;
H. Designate, with the approval of County Council, the bank or banks to be used as County depositories and require them to fulfill all conditions prescribed by law or ordinance;
I. Invest funds deemed by the Chief Financial Officer available for temporary investment in such obligations or in such manner as the County Executive may authorize." (Note: This same language is in Delaware State Code, Title 9, Section 1371.)

NCC Code, in Article 1, Sections 14.01.013 through 14.01.015, establishes reserve accounts as follows:

- General Fund Budget Reserve: "The budget reserve was legislated to set aside resources of twenty percent of the General Fund's Fiscal Year revenue budget to cover unanticipated deficits or revenue reductions caused by a turbulent economy and/or unfunded legislated mandates. A ten-thirteenths vote from County Council is needed to appropriate these funds for the established conditions or to change the percentage allocated to this fund."[1] This reserve is budgeted as $33,641,626 for Fiscal Year 2015.
- General Fund Tax Stabilization Reserve: "This reserve account was legislated so that funds could be appropriated as necessary to balance the annual operating budget or to cover budgeted capital costs that would otherwise require the issuance of bonds or an increase in the tax rate. County Council is authorized to establish these reserves and appropriate these reserves as may be necessary."[2] This reserve is budgeted as $50,978,906 for Fiscal Year 2015.
- Sewer Fund Budget Reserve: Similar to the General Fund Budget Reserve but based on 20% of the upcoming Fiscal Year budget for the Sewer Fund. This reserve is budgeted as $14,201,372 for Fiscal Year 2015.
- Sewer Rate Stabilization Reserve: Similar to the General Fund Tax Stabilization Reserve. It is designed to cover budgeted capital costs that would otherwise require the issuance of bonds or an increase in the sewer rate. This reserve is budgeted as $13,855,934 for Fiscal Year 2015.

The total of these four reserve accounts for Fiscal Year 2015 is $112,677,838. These reserve funds are managed by two outside investment managers, UBS Financial Services (UBS) and Wilmington Trust Company (WTC).

NCC Code Section 14.10.012.C also provides for a "reserve" fund as follows: "Proceeds from the real estate transfer tax received in any fiscal year in excess of those certified shall be designated as cash in lieu of capital bond authorizations that would ordinarily be used to support construction of capital facilities, or land acquisition, economic development programs, or to defease or otherwise reduce the County's indebtedness." The balance in this reserve was approximately $9 million at June 30, 2014. County Council is authorized to appropriate these funds as may be necessary.

Note 2 in the Notes to the Financial Statements in the June 30, 2014 CAFR (Comprehensive Annual Financial Report) indicates that the County's investment portfolio had a market value of approximately $200 million. (Please note that this is the County's investment portfolio and includes the OPEB [Other Post-Employment Benefits] Fund investments; it does not include the Pension Fund's investments.) Thus, the County's investment portfolio contains not only the various County reserve funds but also other invested funds. These other invested funds (other than the OPEB Fund investments which were not covered on this audit) are generally invested by the Office of Finance, through Wells Fargo and WSFS, in short-term investment vehicles such as money market funds and certificates of deposit (CDs).

[1] From Fiscal Year 2014 Comprehensive Annual Financial Report, Footnote 19.
[2] See above footnote.

The Office of Finance, as of the time of the audit, had the following investment policies:

- "Sewer Reserves", dated August 6, 2004 and approved in writing by the then-CFO (but not by the County Executive). The Office of Finance informed us that this policy also pertains to the General Fund reserves and that it is the policy currently being followed by WTC. See Appendix A.
- "Reserve Fund." This document indicates that it was adopted on May 15, 2014 but it is not signed by anyone. The Office of Finance informed us that this is the policy which is anticipated to replace the "Sewer Reserves" policy and it will pertain to all NCC reserves. (This is also what the Office of Finance originally informed the New Castle County Financial Advisory Council.[3]) See Appendix B.
- "Operating Funds Short-Intermediate Term Portfolios", dated February 21, 2014 and approved in writing by the current CFO (but not by the County Executive). An earlier version of this policy (dated March 16, 2004) was followed by WTC as well as by one of the County's prior investment managers. See Appendices C and D.
- "Short-Term Operating Funds", dated February 21, 2014 and approved in writing by the current CFO (but not by the County Executive). The Office of Finance informed us that this is a policy which was once followed by WTC for a portion of the funds managed by them. See Appendix E.
- "Investment Policy Statement" for Garstin Trust, dated July 26, 2006 and not signed by anyone. Please note that the Garstin Trust[4] was not covered on this audit.

Audit Objectives

The objectives of this audit were as follows:

1. Ascertain and evaluate investments testing performed by the external auditors of the County's financial statements.
2. After gaining an understanding of NCC's investment policies and investment managers, and determining which policies each of the investment managers is/was following, evaluate whether managers are/were in compliance with the applicable investment policies.
3. Determine whether any changes to investment managers, investment advisors, and/or custodians were completed in accordance with County Code and best practices.
4. Evaluate whether contracts with the investment managers have been reviewed by the Office of Law and whether such contracts reflect best practices.
5. Determine whether NCC's reserve accounts are being administered in accordance with County Code and the edicts from the Korn v. New Castle County lawsuit.[5]
6. Evaluate internal controls over the following:
   - Monitoring of investments to determine whether investment managers are complying with investment policies.
   - Monitoring of investments to evaluate investment managers' performance versus investment policy benchmarks.

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[3] Note: At the February 10, 2015 NCCFAC meeting, the CFO stated that this policy is now the official policy for the County's reserves.
[4] The Garstin Trust is an endowment established from a residuary trust, with the income from the endowment to be used for the care, maintenance, and upkeep of parks under New Castle County jurisdiction.
[5] Korn v. New Castle County, C.A. No. 767N, 2005 WL 396341 (Del. Ch. Feb. 10, 2005)

- ➢ Collection of dividend and interest payments.
- ➢ Reconcilement of custodians' investment holdings versus County's records.
- ➢ Adequate segregation of duties between key functions.
- ➢ Adequate policies and procedures.

7. Evaluate financial statement footnotes and the official statements from the latest County bond issuance to determine whether they properly represent the County's investments and investment policies.
8. Evaluate transparency to County Council and the public regarding County investment policies and investment performance.

Scope

We conducted our audit in accordance with Generally Accepted Governmental Auditing Standards promulgated by the United States General Accounting Office. Professional auditing standards require that we plan and perform the audit to obtain reasonable assurance whether internal controls are adequate in all material respects.

In general, our testing involves audit sampling. We evaluate the results of the tests and use professional judgment, based on the number of exceptions and/or the materiality of such exceptions, whether to include exceptions in the audit report and, if so, in which category to include them. In some cases, we perform additional testing to help us obtain additional audit evidence in making such evaluation and determination.

Because the scope of an audit does not allow us to examine every single function and transaction performed by an area, an audit would not necessarily disclose all matters that might be material weaknesses, significant deficiencies, or other reportable items.

Response

Management's responses to the individual comments are incorporated into the report along with the County Auditor's evaluation of each response.

Please note that management had provided a General Comment in their response. At the Audit Committee meeting on April 23, 2015, the Audit Committee voted to approve the report and responses after removing the General Comment. Therefore, that General Comment does not appear in the final report.

We also removed one paragraph of management's response to the recommendations in comment #9. We changed the audit report based upon this paragraph and, therefore, the paragraph was no longer necessary.

Also, please note that we had to retype all of the management responses from a hard copy of the responses. During the weeks of 8/31/15 and 9/7/15, we tried to access our archived emails to retrieve the electronic version of the responses; however, due to system problems, we were unable to do so. Therefore, although we were careful in our typing, we sincerely apologize if we mistyped any portion of management's responses.

cc: Samuel Guy, Deputy Chief Administrative Officer
James McDonald, Chief of Staff
Antonio Prado, Communications Director
New Castle County Council Members
New Castle County Audit Committee Members

General Comment – Public Fund Investing[6]

Executive Summary

Public fund investing is unique. The Executive and Legislative branches, as well as taxpayers, must understand the objectives of public fund investing and the factors/decisions involved in addressing those objectives.

Comment

Note: Our intent in making this comment is not to criticize or opine on any investment philosophy decisions made by management. Our intent is simply to ensure that readers of this comment (and of this report) understand the factors/decisions involved in public fund investing.

There are three primary objectives of public fund investing:

- Safety of principal.
- Liquidity: the ability to meet financial obligations – planned and unplanned – as they present themselves, without having to sell a portfolio security at a principal loss.
- Income.

Because these three objectives are mutually exclusive to some degree, each imposes constraints on meeting the others. For example, maximizing safety of principal reduces the opportunity to maximize income, and vice versa. In weighting these objectives, many public fund managers give a total combined weight of 80% to 95% to safety and liquidity.

As of November 21, 2014, UBS Financial Services (UBS) had reduced the average effective maturity of fund securities to 1.56 years since they began managing a portion of the County's reserves. They had also reduced the average modified duration[7] to .76 years. (The securities invested by one of the prior investment managers, per an investment presentation dated May 25, 2012, had a duration of 3.3 years.) This has served to decrease the interest rate risk[8] of the portfolio which in turn has increased the liquidity and safety of the portfolio. On the other hand, it has most likely served to reduce the income generated by the portfolio because management has apparently made a decision to forsake additional income in exchange for having increased liquidity and safety. Again, this is a management decision and we do not opine upon it.

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[6] Note: Most of the concepts presented in this comment are taken from the book "The Politics of Public Fund Investing", written by Ben Finkelstein. Mr. Finkelstein is a Managing Director at Cantor Fitzgerald. He is a nationally recognized consultant, lecturer, and published author in the public funds investment community.

[7] Duration is the measure of a bond's price volatility in the face of interest rate changes. Duration provides the fund manager with a reliable means of quantifying the portfolio's expected change in value based on small changes in interest rates. As an example, let's suppose a bond priced at par has a dollar price of 100 with a duration of 4.00. Should rates move up or down 1% (100 basis points), the price of the bond would be expected to change by 4%, to either 96 or 104 depending on the direction of the rate change. Higher duration translates to higher price volatility due to interest rate changes – and vice versa. Duration is a much more appropriate reflection of the portfolio's true interest rate risk than is average effective maturity.

[8] Interest rate risk is the market price volatility that fixed-income securities experience as a consequence of changing market interest rates.

We, as auditors, make no judgment regarding the weight to be given to the various investment objectives. However, we believe that those responsible for administering County funds, whether management and/or County Council, in an oversight or advisory capacity, need to determine a suitable risk tolerance regarding its ability and willingness to take risks. For example,

- Liquidity risk: What percentage of the portfolio must be earmarked to ensuring that securities will not have to be sold prematurely to meet an obligation? Given that the County's reserves are infrequently accessed (except for the $15 to $30 million a year "borrowing" during the summer months), perhaps some portion of the reserves can have less liquidity and more opportunity for income.[9] A public fund does have an obligation to ensure that funds not earmarked for liquidity are invested prudently for income.
- Interest-rate risk: How much is management willing to tolerate in principal value fluctuations in order to optimize income?
- Credit risk: How much is management willing to tolerate in reducing average weighted credit value ratings to achieve more income? For example, to what extent should one invest in higher-yielding investment grade issues versus default-free Treasury securities?
- Reinvestment risk: Callable and mortgage-backed securities may cause fund managers to have to reinvest principal (before maturity) at future, unknowable rates.

At the November 18, 2014 NCCFAC (New Castle County Financial Advisory Council) meeting, a couple of the NCCFAC members discussed having a process in which the County's risk tolerance is evaluated annually and is formally identified and expressed. Also, the Reserve Fund policy states that the CTC (CFO, Treasury Manager, Cash Manager) have the responsibility for determining risk tolerance.

Recommendation – Office of Finance

We recommend that the Office of Finance, Executive Office, and the County Council Finance Committee[10]:

- Reach and document an understanding of the County's ability and willingness to take risks as they apply to the safety and liquidity investment objectives versus the income objective.
- Make it a formal requirement that such risk tolerance level be evaluated by the appropriate parties annually.

Management's Response – Office of Finance

The audit report incorrectly presumes the County has not established a suitable risk tolerance. Prior administrations condoned investments in higher risk securities. The Gordon Administration no longer invests County operating reserves in high risk securities such as junk bonds. We are in agreement that portfolio risk was reduced by moving the funds to UBS and restructuring County investment holdings.

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[9] The policy of the State of Delaware's Cash Management Policy Board distinguishes between the State's reserve and other funds and states "This fund will be managed and invested by an investment manager or managers, selected by the Board after a competitive bid, in order to maximize the return on said money to the State while providing for the safety of principal."

[10] And Investment Board if one is so created by County Council.

The County's risk tolerance is evaluated periodically by the appropriate party, i.e., the Chief Financial Officer as directed by the County Executive. The New Castle County Financial Advisory Council ("NCCFAC") voted, during its April 2015 meeting, to remove itself from any involvement of providing investment advice, which is outside the scope of their jurisdiction.

County Auditor's Evaluation of Response

We believe that determining a suitable risk tolerance is much more than making a statement that the County will not invest in junk bonds. As outlined above (in the paragraph listing four risk categories), it includes a determination of the County's ability and willingness to take risks. We believe this determination should be performed, documented, and explained to County Council and to the taxpayers.

The Reserve Fund Investment Policy Statement (Appendix B) states that the CTC (Chief Financial Officer, Treasury Manager, and Cash Manager) "shall have direct responsibility for the oversight and management of the assets and for the establishment of investment policies and procedures." Among other things, the CTC will "Determine risk tolerance and investment horizon, in turn establishing reasonable and consistent investment objectives, policies, and guidelines which will direct the investment of the assets as reflected in the IPS" (Investment Policy Statement).

The IPS also states that the CTC is involved "In setting the risk and liquidity parameters for the management of the assets …" and that "The CTC shall seek to ensure that the risks taken are appropriate and commensurate with the assets' goals."

We have not seen any evidence that the CTC, in the last couple of years, has formally evaluated risk tolerance.

Regarding the statement that NCCFAC voted to remove itself from any involvement of providing investment advice, NCCFAC was never asked by County Council to provide investment advice. County Council, per resolution, asked NCCFAC to review the existing County investment policies for the County's reserves. The County Auditor was in attendance at the NCCFAC meetings where this request was discussed. NCCFAC Members agreed that they would be providing insights on the policies (mainly the processes), not providing any advice on how the County should invest its money.

Also, given that the General and Sewer Fund budget reserves (i.e., "Rainy Day Funds") are much less likely to be accessed than the Tax Stabilization and Sewer Rate Stabilization reserves, we believe that management may want to consider having different risk tolerances for the Rainy Day Funds. The State of Virginia, for example, has an Extended Duration Portfolio for funds which are not needed for immediate liquidity. This portfolio, which is structured into three sub-portfolios (Short, Intermediate, Long), assumes additional interest rate and credit risk within prudent constraints.

General Comment – County Reserves

Comment

The level of the County's reserve funds (see page 2 for a listing of these) is an important element in bond rating agencies assessing the strength of the County's financial condition. For example, Fitch Ratings in assigning an AAA bond rating to New Castle County general obligation bonds in January 2015 stated "The County's maintenance of high reserves continued in fiscal 2014 … The fiscal 2015 budget is balanced without the use of reserves …"

Thus, the County Auditor's Office believes that the County Administration and the County Council must make a concerted effort to ensure policies, procedures, and processes regarding the County's reserve funds are thorough, understandable, and transparent so that taxpayers' funds are adequately controlled and protected, and also generate a reasonable rate of return respective to the County's risk tolerance level.

We believe there has not been sufficient transparency to the public regarding the County's investment policies, the selection of investment managers, the performance of the County's portfolio versus the relevant benchmarks, and the various processes regarding the County's investment portfolio. We believe the State of Delaware, through its Cash Management Policy Board, achieves greater transparency regarding these items than does the County. We believe New Castle County taxpayers have a right to know more about the protection and performance of their hard-earned taxpayer dollars.

We have provided information in Appendix K on the investment performance of current and past investment managers investing the County's reserves.

We hope that this audit report has brought important issues to light so that the County Administration and County Council can work together to implement best practices over the County's reserves.

Audit Objective: After gaining an understanding of NCC's investment policies and investment managers, and determining which policies each of the investment managers is following, evaluate whether managers are in compliance with the applicable investment policies.

1. *Compliance with State and County Codes regarding Investment Authority*.

Executive Summary

State and County Codes allow the CFO to invest funds "as the County Executive may authorize." However, the County Executive has not formally signed the County investment policies under which investments are made. We recommend that the County Executive sign the existing, and any future, investment policies.

Comment

New Castle County (NCC) Code Section 2.05.503 states "The Office of Finance, managed by the Chief Financial Officer … may perform the following functions …

I. Invest funds deemed by the Chief Financial Officer available for temporary investment in such obligations or in such manner as the County Executive may authorize." (Note: This same language is in Delaware State Code Title 9, Section 1371.)

None of the existing investment policies have been signed by the County Executive. Therefore, we are of the view that existing County investment policies cannot technically be deemed official policies and County investments made pursuant to the policies have technically not been properly authorized, per State and County Codes, by the current and past County Executives.

Certainly the current and past County Executives may have reviewed and verbally approved such investment policies; however, without having a signature of the County Executive on the investment policy (or some other document), there is no evidence of this.

Recommendation –Executive Office

On September 23rd, 2014, County Council passed a resolution requesting "… the members of the New Castle County Financial Advisory Council utilize their professional expertise to review New Castle County's current investment policies and provide recommendations to improve or clarify current practices."

We recommend that the County Executive formally approve any existing investment policies currently being utilized by the County and its investment managers, as well as any new/revised policies developed as a result of the NCCFAC review.

Management's Response –Office of Law

Initially, the Office of Law disagrees with the Auditor's interpretation of Delaware and New Castle County Code. Title 9 De. C. Section 1371(9) and NCC Code Section 2.05.503.I empower the Chief Financial Officer to invest funds he/she deems available for temporary investment, in such obligations or in such manner as the County Executive may authorize. There is no requirement for written authorization and no prohibition against department and office manager from implementing policies/procedures necessary to fulfill their duties. In addition, the past practice of the County's Chief Financial Officer is to issue investment policies under his/her own hand, not under the signature of the County Executive. Therefore, the Audit Report makes an unreasonable conclusion regarding the official nature of the County's investment policies.

County Auditor's Evaluation of Response

We agree that State and County Codes do not require written authorization. However, the fact that it has been a past practice for the CFO's signature to be the sole signature on investment policies is, in our opinion, not a valid reason for the County Executive's signature not to be included. Also, the Investment Policy Statement for the Reserve Fund, adopted May 15, 2014, does not reflect the signature of anyone at all.

We still believe, from a best practice standpoint, that the County Executive should affix his signature to all County investment policies, particularly since the County Executive's authorization is the only authorization of a County official required by State and County Codes.

2. ***Investment Policies followed by Investment Managers.***

Executive Summary

In our opinion, there was a lack of understanding among key Office of Finance personnel on which investment policies are being followed by UBS Financial Services (UBS) and Wilmington Trust Company (WTC), and whether UBS has been investing funds in accordance with an Office of Finance approved investment policy. In particular, we received different answers from different people regarding the policy UBS has been following. In the future, we recommend investment managers be required to comply with a formal investment policy which has been formally approved by the CFO and County Executive.

Comment

On February 12, 2013, a First Assistant County Attorney issued a memorandum to the CAO stating:

"This memo is to confirm that New Castle County may enter into contractual relationships with investment managers to assist in the prudent and strategic management of the County's investment portfolio … The authority of any investment manager so retained by the County is, however, **subject to the investment objectives set forth in the New Castle County Office of Finance Investment Policy**" (bold added).

We had difficulty ascertaining which, if any, Office of Finance investment policy UBS has been following in managing the County's funds. We believe a major reason for this is that the two Office of Finance employees responsible for the investment portfolio for several years were not involved at all in the decision to move $92 million to UBS nor in any subsequent decisions/monitoring regarding UBS. The Office of Finance's investment policies are outlined on page 3 of this report.

Reasons for our difficulty in determining which policy(s) UBS has been following are as follows:

- The contract with UBS does not refer to a specific Office of Finance investment policy but does include a section on "Return Objectives / Risk Tolerance." The following boxes are checked in this section:
    - "Risk Tolerance: Low Risk."
    - "Investment Objectives: Produce current income."
    - "Risk Return Objectives: I prefer to sustain only moderate fluctuations in the value of my assets to achieve moderate returns."
    - "Investment Time Frame: 3 to 6 years (an average market cycle)." Please note that this section refers to the average length of time an investment is held before it's liquidated.
- In February 2014, we met with the CFO and the two Office of Finance employees responsible for overseeing the County's investments. At the meeting, we were told that UBS was providing interim guidance on how to re-invest maturing principal in safe, short-term instruments but that no active strategy was being followed. The intent was to return to an active investment strategy once the RFP process was completed and a new investment manager was selected. In March of 2014, we met with the CAO and expressed surprise at the number of trades being performed by UBS given that the CFO had told County Council that UBS was a temporary custodian and was not acting as Investment Manager. The CAO told us that UBS was basically liquidating investments transferred from a certain investment manager and investing the funds in shorter-term, safer investments. It was our understanding from these meetings that UBS was not following one of the Office of Finance's investment policies.
- In April 2014, we met with one of the Office of Finance employees responsible for monitoring County investments. In this meeting, this employee told us that he wasn't sure which investment policy UBS was following because he had not been involved in contracting with UBS or in any subsequent meetings with UBS.
- In July 2014, we sent an e-mail to the CFO and the two Office of Finance employees responsible for monitoring County investments, asking which investment policy UBS was following. In response, we were informed that UBS was following the Reserves policy. We then inquired whether UBS had followed the "Sewer Reserves" policy through May 15, 2014 and then the "Reserve Fund" policy which was apparently adopted (but not signed) on May

15, 2014. We received a response which stated that there was a May 7, 2013 Memorandum of Understanding (MOU), between UBS and the County, that outlined UBS's understanding of how the County wanted them to invest the funds. This was the first time anyone had mentioned this MOU to us. The individual responding told us that he had never been aware of it either. The MOU, which is embodied in an e-mail to the CFO recapping a telephone conversation, states:

> "MEMORANDUM OF UNDERSTANDING
>
> REPOSITION ACCOUNT HOLDINGS TO 5 YEARS OR LESS DURATION May 7, 2013
>
> Value as of 5/6/13: $93,381,950.58
>
> Performance/Portfolio detail through 5/6/2013: see attached Portfolio Management Report.
>
> Goal: Restructure current portfolio to shorten average duration of fixed income to under 5 years.
>
> Security sales values subject to market pricing/spreads.
>
> Will report status weekly with anticipated completion by May month-end …"

The MOU is not typical of an MOU we are used to seeing, i.e., a formal legal document between two entities, signed by management representatives of both entities. Also, the MOU makes no mention of having to follow any Office of Finance approved investment policy nor does it mention anything about the quality of the securities to be invested in.

- The New Castle County Financial Advisory Council (NCCFAC) has been asked by County Council, per resolution, to review the existing County investment policies for the County's reserves. When one of the Co-Chairs of the County Council Finance Committee (Co-Chair) asked the CAO for the County investment policies, he was initially given two policies: the Short-Term Operating Funds policy and the Operating Funds Short-Intermediate Term Portfolios policy. When the Co-Chair presented these policies to NCCFAC in September 2014, the CFO did not mention that there were other policies. After the meeting, the County Auditor told the Co-Chair that there were other policies, i.e., the Sewer Reserves policy and the draft Reserve Fund policy; the Co-Chair then asked the Office of Finance for these policies and such policies were presented to NCCFAC at the November 2014 meeting. Thus, NCCFAC has now been given four different policies regarding the County reserves, a further indication that there is confusion regarding which policy UBS has been following.
- At the November 18, 2014 NCCFAC meeting, there was discussion regarding the various policies.
    - One of the members asked the CFO whether all four policies are still in effect and he was unable to give a definitive answer. This same member said that NCCFAC members had

received an email stating that one policy (the Sewer Reserves policy) was no longer in effect.
  - The CFO said that the Office of Finance was trying to make the Reserve Fund policy the official policy for the reserves but that the Sewer Reserves policy was still technically the policy. He said that once the new one became official, the Sewer Reserves policy would go away.
  - The CFO said it's been past practice that a policy becomes official once it is signed. However, the Reserves Fund policy is not signed.
  - One of the County Council Finance Committee Co-Chairs asked whether there are currently any funds being invested under the Sewer Reserves policy, and he did not receive an answer to his question. (Please note that we called Wilmington Trust Company and were informed that they are following the Sewer Reserves Policy.)
  - The County Auditor said that he thought UBS was following the Sewer Reserves policy and the CFO answered that it depends on who has the sewer reserves.
- The Reserve Fund policy creates a team called the CTC (CFO, Treasury Manager, and Cash Manager). Pages 8 and 9 of this policy state that the investment policy "should be reviewed annually by the CTC … the CTC shall set forth guidelines for managing investment assets …" Since it is our understanding that the Treasury Manager and the Cash Manager had minimal involvement in the review of the Reserve Fund policy and the setting of guidelines for it, we question whether this policy can be considered an official Office of Finance approved policy.
- We met with UBS in November 2014 and were told that they are following the "Reserve Fund" Policy, which states on the cover page that it was adopted on May 15, 2014. However, this policy is not signed by anyone and it was given to NCCFAC with the instruction that it is intended to be the <u>future</u> policy for the reserves. In addition, we note that UBS was making investments for the County prior to May 15, 2014.
- A previously-engaged consultant for the County's investment portfolio informed us that a prior investment manager was following the Operating Funds Short-Intermediate Term Portfolios policy (but the Sewer Reserves policy for the performance benchmarks), so it would be logical to think that the securities transferred from this manager to UBS would be managed under that policy.
- Footnote #2 in the County's June 30, 2014 audited financial statements identifies (by its description) the "Reserve Fund" policy as the allowable policy for "longer-term reserves portfolios." However, Wilmington Trust Company (also responsible for managing a portion of the County's reserves) is following the "Sewer Reserves" policy.

Recommendations – Office of Finance

If a situation occurs again where County reserves need to be placed with a temporary custodian / investment manager, we recommend that such manager be asked to comply with an investment policy approved by the CFO and County Executive.[11] If such a relationship warrants investing in a different manner than a properly-approved policy, we recommend that a new investment policy be prepared and that it be approved by the CFO and County Executive.

[11] If an Investment Board is created and/or County Council passes legislation requiring Council approval of investment policies, obviously these entities would need to approve the policy also.

We also recommend that:

- All investment managers be required to follow an investment policy approved by the CFO and County Executive.
- Each Office of Finance approved policy be signed by the County Executive as well as by the CFO.[12]
- The Office of Finance maintain documentation on the investment policy each investment manager is following, share this information with County Council, and consider putting the policies on the Office of Finance webpage.
- The Office of Finance periodically review investment manager portfolios for compliance with policy.

Management's Response – Office of Finance

While many New Castle County investment policies have existed, some concurrently, they are all consistent on the issue of credit quality. In fact, all County issued investment policies restrict, or have restricted, fixed income investments to those rated "investment grade" or above. UBS in its early role as temporary custodian, and current role, has placed all County assets in investment grade or higher financial products.

In addition, all Investment Managers selected by the Gordon Administration follow approved investment policies. The Office of Finance will continue monitoring investment manager portfolios with the newly selected Investment Advisor. The Office of Finance will work with the County Council Finance Committee to establish better communication procedures.

Separately, the Audit Report's statement on page 14, bullet five states "since it is our understanding that neither the Treasury Manager nor the Cash Manager had any involvement in the review of the Reserve Fund policy and the setting of guidelines for it" is incorrect. The Treasury Manager and Cash Manager were integral components in the development of the Reserve Fund Policy.

County Auditor's Evaluation of Response

Management did not address the first recommendation regarding any future situations where County reserves are placed with a temporary custodian / investment manager, i.e., ensure the entity complies with an investment policy approved by the CFO and County Executive.

The Reserve Fund Policy, apparently adopted in May 2014, is not signed by anyone. Given the Office of Law's prior statement that "the past practice of the County's Chief Financial Officer is to issue investment policies under his/her own hand, not under the signature of the County Executive", we question whether this policy is an official County investment policy.

The response states that "The Office of Finance will work with the County Council Finance Committee to establish better communication procedures." The County CFO, at a County Council Finance Committee meeting on September 29, 2015, informed Council that the County's

[12] See Footnote 9.

new Investment Advisor will make quarterly reports to Council on the performance of the County's investment portfolio. However, recent discussion with the Finance Committee Co-Chairs revealed that the Office of Finance has not contacted the Finance Committee regarding putting investment information on the County website.

We will change the wording regarding the involvement of the Treasury and Cash Managers in the development of the Reserve Fund Policy. However, we believe (based on discussions with them) that their involvement was minimal.

3. *Compliance with Investment Policies.*

Executive Summary

Our testing of investment managers' compliance with the applicable investment policies revealed a few exceptions which we do not consider to be material. However, such exceptions highlight the fact that there does not appear to be anyone periodically, and formally, reviewing the investment portfolios to determine policy compliance.

Comment

We tested whether two of the prior investment managers (which we call Managers A and B here) were investing in accordance with the applicable Office of Finance investment policy as of June 30, 2012, the last year-end these investment managers were responsible for investing County funds. (Note: For restricted securities, we tested as of the month-end before the managers were terminated.) We tested whether Wilmington Trust Company (WTC) and UBS were investing in accordance with the applicable Office of Finance investment policy as of June 30, 2014, the most recent year-end. Since UBS informed us that they have been investing in accordance with the "Reserve Fund" policy since May of 2014, we tested their investment portfolio against this policy. The items in **bold** below are apparent exceptions to the applicable policy.

<u>Manager A – (followed the Operating Funds Short-Intermediate Portfolios Policy[13])</u>

Corporate Bonds –

- A maximum of 50% of the portfolio may be allocated to corporate bonds: Using the market value of the investments, the percentage of the portfolio invested in corporate bonds as of June 30, 2012 was 34.2%, well below the allowable limit.
- Investment grade only: All securities were investment grade (i.e., Baa2/BBB or higher) as of June 30, 2012.
- Average weighted credit quality A+/A1 or higher for this portion of the portfolio, as rated by Moody's or Standard and Poor's: **Using the market values provided by the investment manager and using a graduated scale for credit ratings with a 6 being A+/A1, our**

[13] The prior investment consultant informed us that the Sewer Reserves policy was intended to replace the Operating Funds Short-Intermediate Term Portfolios policy, and that Manager A and WTC were following certain aspects of the Sewer Reserve policy. Therefore, if our testing revealed an exception to the Operating Funds Short-Intermediate Funds policy, we checked whether such exception would have been an exception under the Sewer Reserves policy.

calculations showed that the average weighed credit quality, as of June 30, 2012, was 5.56 for S & P and 5.61 for Moody's. Although not a significant difference, the average weighted credit quality was technically below the standard. Please note that the new Reserve Fund policy has a minimum average credit rating of A (<u>for the entire portfolio</u>, not just for corporate bonds), which would be a 5 on the graduated scale.

- There was one Canadian corporate bond. The policy allows for dollar denominated issues of corporations with a major presence in the U.S. Our research indicated that this company has a major presence in the U.S and the securities were denominated in dollars.

Asset-Backed Securities: As of June 30, 2012, 7.8% of the market value of the portfolio was invested in these securities, which is below the Sewer Reserve policy's limit of 15%[14]. Also, per policy, all securities were investment-grade and rated AAA by at least one major rating agency.

U.S. Government Agency/Instrumentality Obligations: As of June 30, 2012, 55.7% of the market value of the portfolio was invested in these obligations, of which there is no percentage limit in the policy.

- **There were five Canadian government (either Canada or one of its provinces) securities in the portfolio. The market value of these represented approximately 5.3% of the total market value of the portfolio as of June 30, 2012. The policy does not allow for non-U.S. Government securities. While this constitutes an exception to policy, we believe there is adequate documentation/reasoning to support these investments:**
  - **In a May 8, 2012 cover letter to the monthly statement, Manager A informed the Acting CFO "… we have sold corporate bonds issued by financial firms as spreads on these bonds fell. We used the proceeds to buy bonds issued by high quality industrials, Canadian sovereigns, and oil and gas producers. These high quality corporate bonds will benefit if Treasury yields fall due to a weaker U.S. economy, or likely outperform when the U.S. reaches its debt ceiling once again." We are not aware of the Acting CFO raising any objections to these investments.**
  - **In an April 10, 2012 cover letter to the monthly statement, Manager A informed the Acting CFO "… For our strategies that allow corporate bonds, we have complemented our traditional relative value analysis with two modifications. First, we have added bonds that will outperform due to a weak U.S. dollar … Another example includes purchasing bonds from non U.S. based companies and highly rated government bonds of foreign countries with stable ratings. While the bonds are still dollar denominated, they have generally outperformed when the dollar has declined and/or as the United States debt to GDP ratio has worsened." We are not aware of the Acting CFO raising any objections to these investments.**
  - **The Canadian bonds are U.S. dollar denominated, trade in the U.S., and are registered with the SEC. Such securities are called "Yankee bonds."**

Money Market Funds: As of June 30, 2012, 2.3% of the market value of the portfolio was invested in money market funds, well below the policy limit of 15%.

[14] The Operating Funds Short-Intermediate Funds policy does not allow for investments in asset-backed securities.

Restrictions: As of January 31, 2013 (the last month-end before Manager A was terminated), the portfolio was not invested in derivative securities (such as options and futures), collateralized mortgage obligations (CMO's), or zero-coupon bonds.

Wilmington Trust Company (WTC) – (following Sewer Reserves Policy)

Corporate Bonds –

- A maximum of 60% of the portfolio may be allocated to corporate bonds: Using the market value of the investments, the percentage of the portfolio invested in corporate bonds as of June 30, 2014 was 46.6%, which is below the allowable limit.
- Investment grade only: All securities were rated investment grade (i.e., Baa2/BBB or higher) by either Moody's or S & P as of June 30, 2014.
- Average weighted credit quality A+/A1 or higher for this portion of the portfolio, as rated by Moody's or Standard and Poor's: **Using market value and using a graduated scale for credit ratings with a 6 being A+/A1, our calculations showed that the average weighted credit quality, as of June 30, 2014, was 3.53 for S & P and 3.30 for Moody's. This equates to an average weighted credit quality of between BBB+/Baa1 and A-/A3, which is below the standard.** Please note that the new Reserve Fund policy has a minimum average credit rating of A (for the entire portfolio, not just for corporate bonds), which would be a 5 on the graduated scale.
    - We tested whether WTC was in compliance with the Reserve Fund policy as of June 30, 2014. The average weighted credit quality as of this date was 6.88 (using Moody's because S & P does not assign a rating to U.S. Treasuries), which is above the rating of 5 in the Reserve Fund policy.

U.S. Treasury and U.S. Government Agency/Instrumentality Obligations: 53.2% of the portfolio is invested in these obligations, of which there is no percentage limit in the policy.

Money Market Funds: As of June 30, 2014, less than 1% of the market value of the portfolio was invested in money market funds, well below the policy limit of 15%.

Restrictions: As of June 30, 2014, the portfolio was not invested in derivative securities (such as options and futures), collateralized mortgage obligations (CMO's), or zero-coupon bonds.

Manager B – (followed the Investment Policy Statement – Cash Management, See Appendix F)

We reviewed the investment portfolio, comprised of mutual funds, as of June 30, 2012 and again as of January 31, 2013 (the last month-end before Manager B was terminated). We also looked at a Position Analysis prepared for the County by Manager B, dated December 31, 2012; this position analysis places each of the mutual funds held in the portfolio into the tiers addressed in the Investment Policy Statement.

A key section of the policy states "The portfolio may not directly invest in individual securities including stocks and bonds, as well as derivatives such as options, futures contracts, swaps or other over-the-counter hedging instruments. The strategy will be executed through the use of open-ended 1940 Act mutual funds."

In our opinion, there were shortcomings with the Investment Policy Statement as follows:

- Although the other County investment policies all make it a requirement that securities be of investment grade quality, this policy did not. Thus, although Manager B technically met the requirements of the policy for the two mutual funds which had holdings in "junk bonds" (i.e., bonds which are less than investment grade, or less than Baa2/BBB), in our view there was a shortcoming in this policy (since investment grade quality appears to be as key component in other County policies).[15] Since public comments have been made by the County Administration regarding the riskiness of these two funds, we feel obligated to note that the mutual funds in which the junk bonds were held are rated "low" for risk in the high-yield bond mutual fund category. That is, both the RiverPark High Yield Bond Fund and the FPA New Income Fund were in the 1st percentile (relative to their peer group) for their Sharpe ratios.[16] Several articles have been written regarding the conservativeness of these funds.[17]
- For the one mutual fund that invested in derivatives, we believe there are arguments on both sides regarding whether this was a violation of policy. For that reason, we don't believe the investment in mutual funds that held derivatives was technically a violation of policy; however, we still feel the policy itself was poorly crafted by the County.
    - On the one hand, the policy contained a prohibition for investing directly in derivatives and it can be argued that such prohibition cannot be circumvented by investing in mutual funds which hold such securities. That is, one can't circumvent the policy by doing indirectly what one is not allowed to do directly. Also, we agree with the County Administration that there are risks (such as credit and market risks) with investing in derivatives. When a derivative is used as a hedge against a position that a Fund holds, any loss generated by the derivative generally should be substantially offset by gains on the hedged investment, and vice versa. However, we do not know the extent to which this fund uses derivatives as a hedging strategy. Also, although hedging can reduce or eliminate losses, it can also reduce or eliminate gains. And hedges are sometimes subject to imperfect matching between the derivative and the underlying security, and there can be no assurance that a Fund's hedging strategy may be effectiveOn the other hand,

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[15] Please note that the investment manager did not invest in these two funds until February 2012 and fully informed the Finance Department of the reasons why.

[16] The Sharpe ratio is a measure of a fund's risk developed by Nobel Laureate William F. Sharpe. The higher the Sharpe ratio, the better the fund's historical risk adjusted performance.

- The Sharpe ratio[16], for the period 10/1/11 through 9/30/14, for the RiverPark Short Term High Yield Fund was 6.13 compared to the median of 1.71 for the peer group. This was in the 1st percentile (the top) for the peer group.
- The Sharpe ratio, for the period 10/1/09 through 9/30/14, for the FPA New Income Fund was 2.70 compared to the median of 1.22 for the peer group. This was in the 1st percentile (the top) for the peer group.

[17] For example, see September 30, 2012 and September 1, 2014 on-line publications of the Mutual Fund Observer, and the July 24, 2012 and August 21, 2014 on-line publications of TheStreet. See Exhibit L.

- The investment policy specifically directed that Manager B utilize mutual funds to construct a portfolio with three tiers of safety and liquidity. The tiers ranged from taxable money markets and short-term fixed income on one end to funds with high-yield exposure on the other. (These tiers were constructed to limit the overall risk exposure of the investment portfolio.)
- Following the logic (in the first bullet above) that a prohibition cannot be circumvented by investing in mutual funds that hold securities which are the subject of such prohibition, this would mean that Manager B could not have invested in mutual funds which held individual securities such as stocks or bonds – or any individual security for that matter (since there was a prohibition against investing in individual securities). Basically, Manager B would not have been able to invest in most mutual funds even though the policy specifically stated that it was to invest in mutual funds. Thus, this logic appears flawed to some extent.
- The Investment Manager informed us that"…derivative exposure was very limited, and indeed had to be. The Investment Company Act of 1940 (i.e. the "1940 Act" referenced in the investment policy statement) imposes significant restrictions on a mutual fund's exposure to derivatives. Indeed, to bring this discussion full circle, those legal limitations were a sound basis for prohibiting direct investment in derivatives, but not prohibiting investment in mutual funds with positions in derivatives."

Should management have a future situation where it would like to invest County reserves in mutual funds, we believe a better-crafted policy should a) expressly prohibit both direct and indirect investment in certain types of investments or instruments, or b) expressly prohibit investment in mutual funds that invest in specified types of investments or instruments, or c) establish a restrictive risk tolerance specific to investments in mutual funds that invest in specified types of investments or instruments.

UBS (apparently following the Reserve Fund policy)

The policy states that the portfolio (as a whole) will have a minimum average credit rating of A as rated by Moody's, S & P, or Fitch. As of June 30, 2014, the portfolio had a minimum average credit rating of 7 (Aa3/AA-) for Moody's and 6.84 (rounds to Aa3/AA-) for S & P. This is well above the required average credit rating of A (which would be a 5). Please note that this calculation does not include the GNMA securities which are not rated.

Corporate Bonds –

- A maximum of 50% of the portfolio may be allocated to corporate bonds: Using the market value of the investments, the percentage of the portfolio invested in corporate bonds as of June 30, 2014 was 42.5%, which is below the allowable limit.
- Investment grade only: All securities but one were rated investment grade (i.e., Baa2/BBB or higher) by either Moody's or S & P as of June 30, 2014. The one security not rated investment grade only represents 1.3% of the market value of the portfolio and it is only one step below investment grade. We believe this exception is immaterial.

- Please note that the new Reserve Fund policy (see discussion above regarding its adoption) does away with the requirement in the Sewer Reserves policy that the corporate obligations segment of the portfolio must have an average weighted credit quality A+/A1 or higher, as rated by Moody's or Standard and Poor's. Given the lack of clarity regarding adoption of the Reserve Fund policy, we also tested fund performance against the Sewer Reserves policy. Using market value and using a graduated scale for credit ratings with a 6 being A+/A1, our calculations showed that, as of June 30, 2014, the average weighted credit quality for the corporate obligations segment of the portfolio was 3.44 for S & P and 3.33 for Moody's. This equates to an average weighted credit quality of between BBB+/Baa1 and A-/A3.

U.S. Treasuries and Agencies: The portfolio is allowed to hold between 10% and 100% of these. 29.2% of the portfolio is invested in these obligations.

Cash and Cash Equivalents: As of June 30, 2014, 20.1% of the market value of the portfolio was invested in cash and cash equivalents (primarily money market funds), well below the policy limit of 50%.

- Please note that the new Reserve Fund policy (see discussion above regarding its adoption) does away with the requirement in the Sewer Reserves policy that the money market funds cannot exceed 15% of the total portfolio. Given the lack of clarity regarding adoption of the Reserve Fund policy, we also tested compliance against the Sewer Reserves policy. As of June 30, 2014, the percentage of the portfolio invested in money market funds (20%) would have been over the limit.

Asset Backed Securities: As of June 30, 2014, 7.3% of the market value of the portfolio was invested in asset backed securities, below the policy limit of 15%.

Restrictions: As of June 30, 2014, the portfolio was not invested in equities, preferred stock, private placements, futures, options, or credit default swaps.

Recommendations – Office of Finance

We recommend that the Office of Finance establish formal policies and procedures for periodically:

- Ensuring County investment managers are investing in accordance with investment policy.
- Reviewing investment manager investment performance against the applicable performance benchmarks.

Management Response – Office of Finance

The Office of Finance has retained a new Investment Advisor to help ensure the County investment managers are investing in accordance with the County's adopted investment policies. The Investment Advisor will also assist the Office of Finance in reviewing the investment manager's performance against applicable benchmarks.

Independently, the Audit Report remarks on a lack of understanding among Office of Finance personnel regarding investment policies. While some members of the Office of Finance may not have properly articulated County policies, we believe the County Auditor's prior public comments and Audit Report's executive summary demonstrate a lack of understanding of certain financial products. In a March 24, 2015 article, the News Journal reported the County Auditor opined on fixed income securities as well as the credit ratings stating "These two mutual funds that invested in junk bonds [prior to UBS] were extremely low risk."

However, junk bonds, by definition, are fixed income securities that are assigned "below investment grade" credit ratings. According to Morningstar, "junk bonds have a high default risk, they are speculative. Default risk is the chance that a company or government will be unable to pay its obligations when the bonds mature."

The Auditor based his assertions from a post on MutualFundObserver.com, a blog site by David Snowball, who also appears on the marketing brochure of the very high yield bond fund the County divested. Based on Mr. Snowball's public image, he appears to be a marketing – not financial -- expert.

The fund prospectuses for the two challenged mutual funds also display their risk. The RiverPark High Yield Fund's prospectus states:

> The Fund invests in fixed-income investments which are or are deemed to be the equivalent in terms of quality to securities rated below investment grade by Moody's Investors Service, Inc. and Standard & Poor's Corporation and accordingly involve great risk."

The FPA New Income Fund's prospectus states:

> "High yield bonds, which are sometimes called "junk" bonds, are highly speculative securities that are usually used by smaller, less credit-worthy and/or highly leveraged (indebted) companies … high yield bonds carry a greater degree of risk and are less likely to make payments of interest and principal.
>
> Insufficient liquidity in the high yield bond market may make it more difficult to experience sudden and substantial price declines."

In an August 13, 2014 News Journal article, the County Auditor attempted to discredit the Administration's rationale for the transfer by asserting a distinction between investing in junk bonds directly or indirectly. "Investing directly in junk bonds is very different than investing in mutual funds Wasserbach said." What he neglected to mention, as it related to credit risk exposure or adherence to an investment policy, is that investing in mutual funds that invest in junk bonds is no different than investing in junk bonds directly.

In an apparent about face, the County Auditor now states, on page 19 of his audit, that "one can't circumvent the policy by doing directly [through mutual funds] what one is not allowed to do directly," which has been the position of the Gordon Administration.

The Audit Report seems focused on the County's 2012 transfer to UBS. The diagram below compares the 2010 and 2012 transfers, both of which occurred during the County Auditor's tenure but under different Administrations.

2010 Transfer	2012 Transfer
No County Executive Approval	Written County Executive Approval
No Council Notification	Council Notified
No RFP	No RFP
Portfolio Risk Increased	Portfolio Risk Decreased
Invested Contrary to Financial Statements	Invested Consistent with Financial Statements
Higher Investment Fees	Lower Investment Fees
County Auditor conducted no audit and made no public comment	County Auditor comments in approximately 10 newspaper articles, leaked documents, and met with journalists, prior to conducting an audit
Occurred under the County Executive and Council President, who appointed the County Auditor	Occurred under a new Administration

County Auditor's Evaluation of Response

Regarding the observations of the County Auditor's public comments:

- The County Auditor informed the News Journal that the two mutual funds were low risk <u>in comparison to other funds in the high-yield bond mutual fund category</u>. The County Auditor, based upon the research outlined in the audit report, stands by that comment. However, the County Auditor does not condone (nor has he ever condoned) investing in junk bonds.
- Publications other than Mr. Snowball's have commented upon the low risk of these funds in <u>comparison to other funds in the high-yield bond mutual fund category.</u>
- In the August 13, 2014 News Journal article, the County Auditor did state that investing in junk bonds directly is different than investing in junk bonds through a mutual fund. However, he made this statement not in the context of any County investment policy but instead speaking from the standpoint of an individual investor. That is, if an individual investor invests $10,000 in a single junk bond, he/she stands more risk of losing his/her principal investment than if he/she invested $10,000 in a mutual fund containing thousands of junk bonds (in which there is diversification of risk).

Regarding the chart presented by management in their response:

- 1st row: 2010 transfer was not encompassed within audit period.
- 2nd row: 2010 transfer was not encompassed within audit period. Regarding the transfer made in early 2013, Council was not notified until November 2013, after a County Council Member became aware of it and asked the CFO to attend a County Council Finance Committee meeting.
- 3rd row: 2010 transfer was not encompassed within audit period.

- 4th row: Agreed.
- 5th row: See audit comment #10 on page 37.
- 6th row: This was not part of the audit but we agree.
- 7th row: 2010 transfer was not encompassed within audit period. As a 1 ½ person department, we cannot audit every County function every year. As a voice for County taxpayers, the County Auditor has every right to respond to press inquiries. In fact, the County Auditor tried to talk the reporter out of doing the first article and then made the CAO aware that there was going to be an article. Also, most of the articles were caused by the CAO publicly criticizing the prior investment managers.
- 8th row: First, the County Auditor is appointed by County Council as a whole; he/she is not appointed by the Council President (except as being part of Council as a whole) or the County Executive. Second, the 2010 transfer was not encompassed within the audit period. As a 1 ½ person department, we cannot audit every County function every year. Also, unlike the 2010 transfer, the Administration received a legal opinion from the Office of Law that the contract did not have to be competitively bid <u>as long as no public funds were being expended.</u>

4. "Temporary Investments" per State and County Codes.

Comment

New Castle County (NCC) Code Article 5, Division 2.05.500, Section 2.05.503 states "The Office of Finance, managed by the Chief Financial Officer … may perform the following functions …

I. Invest funds deemed by the Chief Financial Officer available for temporary investment in such obligations or in such manner as the County Executive may authorize." (Note: This same language is in Delaware State Code, Title 9, Section 1371.)

Neither of these Code sections defines the word "temporary." However, a few definitions found in investment/financial dictionaries are as follows:

- "A short-term investment, such as a money market fund, Treasury Bill, or short-term CD, which is usually held a year or less."
- "An investment in short-term, low-risk securities such as Treasury bills, money markets and so forth."
- "A type of investment that is structured to last for a short amount of time."

These definitions would appear to indicate that County reserve funds, which are typically invested in vehicles having an average maturity of greater than one year, may not meet the definition of "temporary investment" per State and County Codes.

Please note that a County Council Member has introduced legislation to clarify the definition of "temporary investment." At this point in time, we do not have any comment on this legislation.

Recommendations – Office of Law

We recommend that the Office of Law research the legal definition of "temporary investment" per State and County Codes and determine:

- Whether the Office of Finance has the authority to invest in longer-term investment vehicles and, if not,
- Determine who has such authority and whether any legislation needs to be advanced to clarify "temporary investments" versus non-temporary ones, and where authority to make investments other than "temporary investments" lies.

Management Response – Office of Law

The term "temporary investment" is not defined in either the Delaware Code or the New Castle County Code. The term "temporary investment" does not have a consensus legal definition. Further, the term does not have a uniform definition in business. The term is employed by governmental and non-governmental entities to describe specific products and classes of products and also to describe the attributes of products.

Whether the Office of Finance has the authority to invest in longer-term investment vehicles?

Yes. The County has been delegated "powers which, under the Constitution of this State, it would be competent for the General Assembly to grant by specific enumeration, and which are not denied by statute …." 9 Del. C. Section 1101.

Who has the authority to invest in longer-term investments?

The County Executive has such authority and may designate it to the Chief Financial Officer. For example, the Delaware Code and New Castle County Code provide a broad grant of powers for the Office of Finance to act in interests of County citizens:

> Office of Finance; functions
>
> Perform such other functions as may be required of the Chief Financial Officer by this title, or other State law, or which may be assigned in writing by the County Executive.

See 9. Del. C. Section 1371(16) and NCC Code Section 2.05.503P.

There is no need for legislation defining the term "temporary investment" or more specifically designating the authority to make longer-term investments.

County Auditor's Evaluation of Response

The Office of Law has provided its legal opinion. If County Council enacts legislation creating an Investment Board, perhaps such Board can evaluate this issue.

Also, it is our understanding that the County Council Member who introduced legislation to clarify the definition of "temporary investment" will be calling for a vote on such legislation in the near future.

We question the Office of Law's statement that the term "temporary investment" does not have a uniform definition in business, as the three definitions presented in the comment are similar.

Audit Objective: Determine whether any changes to investment managers, investment advisors, and/or custodians were completed in accordance with County Code and best practices.

Background

New Castle County (NCC) Code Article 5, Division 2.05.500, Section 2.05.503 states "The Office of Finance, managed by the Chief Financial Officer … may perform the following functions …

G. Maintain the treasury of the County, and deposit the moneys belonging thereto or in the custody thereof in any depository bank, to the credit of the County;
H. Designate, with the approval of County Council, the bank or banks to be used as County depositories and require them to fulfill all conditions prescribed by law or ordinance;
I. Invest funds deemed by the Chief Financial Officer available for temporary investment in such obligations or in such manner as the County Executive may authorize."

Please note that similar language is in Delaware State Code, Title 9, Section 1371.

In January 2013, the County Administration made a decision to terminate two investment managers (SIT Investment Advisors and West Capital Management) and transfer approximately $92 million in cash and securities to UBS Financial Services (UBS). At a November 26, 2013 County Council Finance Committee meeting, the CFO informed Council "UBS is temporary custodian pending the issuance of an RFP; they are not an investment manager."[18]

5. Was County Council approval of the UBS transaction required?

[18] The RFP was advertised in September 2014, proposals were evaluated, and UBS was selected as the investment manager in February 2015. Thus, UBS acted as "temporary" custodian for two years. Also, UBS was acting as much more than custodian as they were making investment decisions and managing the portfolio.

Executive Summary

The County's engagement of UBS did not require County Council approval.

Comment

We engaged a law firm to provide legal opinions on various aspects of the procurement of UBS. One of the questions presented to them was as follows: "Was County Council approval of the UBS transaction required?"

> The law firm opined as follows: "The transaction did not constitute a 'deposit of monies' in a depository bank so as to require the approval of UBS as a County depository. The relationship of that of a bank and a depositor is different than that of an investor who entrusts funds to a custodian or investment manager." (See Appendix G, page 4 for full opinion.)

Please note that the Office of Law opined in a written memorandum that County Council approval was not required. The Office of Law also engaged a law firm to opine on this issue and such firm also opined that Council approval was not required.

6. Was a competitive bid process required for the UBS transaction?

Executive Summary

The County's procurement of professional services from UBS was not competitively bid in accordance with County Code.

Comment

On February 12, 2013, a First Assistant County Attorney issued a memorandum to the CAO stating:

> "This memo is to confirm that New Castle County may enter into contractual relationships with investment managers to assist in the prudent and strategic management of the County's investment portfolio. To the extent that these services do not require the expenditure of public funds, the procurement of these services is not subject to the bid requirements of the New Castle County Code. The authority of any investment manager so retained by the County is, however, subject to the investment objectives set forth in the New Castle County Office of Finance Investment Policy."

The relevant NCC Code Sections are as follows:

> Article 2, Chapter 5, Section 2.05.501.A states "The Purchasing Section is responsible for obtaining goods and services for public purposes according to the laws and procedures intended to provide for the economical expenditures of public funds."

Article 2, Chapter 5, Section 2.05.502.A states "… Public funds means funds of the County or of the State or of any public school district or of any using agency or of any agency, department, commission, bureau, board or other unit of the government of the State or of or from the United States government or of or from any department or representative body thereof or of or from any combination of any of such."

Article 2, Chapter 5, Section 2.05.502.B.2 states "…

a. Duties of office. Purchasing shall have charge of and be responsible for the procurement of all professional services for the County and all County agencies and using agencies and the entering into of all contracts for such professional services, and the office shall perform its functions and duties and exercise its power and authority for such purchasing and such contracting in accordance with the terms and conditions of this section. The office shall not, however, have charge of or be responsible for the purchasing of the following professional services for the County Employees' Retirement Fund established under Article 4 of Chapter 26 or the Other Post-Employment Benefits Trust Fund established under Article 3 of Chapter 26: brokerage, investment advisory, insurance and actuarial services, which regardless of any ordinance to the contrary, need not be bid.
b. Scope. Subsection B covers the purchase of and the contracting for all professional services by an agency where the probable cost of such services is estimated to exceed fifty thousand dollars ($50,000.00) …
c. Procurement of professional services by purchase order or contract." This section covers the competitive bidding process for professional service contracts. Refer to this section of the NCC Code for more details.

We engaged a law firm to provide legal opinions on various aspects of the procurement of UBS. One of the questions presented to them was "Should the competitive bid process have been followed in the engagement of UBS?"

The law firm opined as follows: "The transaction was subject to the competitive bid process mandated for the award of professional services contracts." (See Appendix G, page 6 for full opinion.)

The Administration informed us that they were following past practices whereby the procurement of prior investment managers had not been done through a competitive bid process. However, it is important to note the following:

- The February 12, 2013 memorandum issued to the CAO by a First Assistant County Attorney stated "To the extent that these services do not require the expenditure of public funds, the procurement of these services is not subject to the bid requirements of the New Castle County Code." The CAO and CFO, who established the account, should have been aware that UBS would be earning "markup" fees on security trades and, thus, public funds would be expended. In our view, the retention of fees is an expenditure of public funds.

- The State of Delaware's Cash Management Policy Board uses competitive bidding in selecting investment managers.
- When one of the prior investment managers was procured in 2010, the Office of Finance did obtain the Clerk of County Council's signature and seal for the use of the custodian of the investments.

Recommendation – Office of Finance

We recommend that the Office of Finance adhere to the County Code regarding competitive bidding for professional services.

Management's Response

As a threshold matter, the County questions the expansive scope of the Audit Report. Sections 5 and 6 appear to represent the County Auditor's attempt to dictate Executive Office and Office of Finance decisions rather than monitor the County accounts, books, and records. The Office of Finance has followed and will continue to adhere to County bidding procedures when required. The Audit Report takes exception to the Gordon Administration's selection of UBS without the benefit of County Council approval, but does not discuss the selection of SIT, West, and Fidelity, whose contracts were not sent to or approved by County Council.

County Auditor's Evaluation of Response

As the County Auditor explained in the meeting with management on the initial draft report, this was a "performance audit" under GAGAS (Generally Accepted Governmental Auditing Standards). Per GAGAS,

> Performance audits are defined as audits that provide findings or conclusions based on an evaluation of sufficient, appropriate evidence against criteria. Performance audits provide objective analysis to assist management and those charged with governance and oversight in using the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability.
>
> Performance audit objectives vary widely and include assessments of program effectiveness, economy, and efficiency; internal control; compliance; and prospective analyses.
>
> Internal control audit objectives relate to an assessment of one or more components of an organization's system of internal control that is designed to provide reasonable assurance of achieving effective and efficient operations, reliable financial and performance reporting, or compliance with applicable laws and regulations.

Also, internal control is defined as "a process, effected by an entity's board of directors, management and other personnel. This process is designed to provide reasonable assurance regarding the achievement of objectives in effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations."

Thus, it is clear that performance audits and evaluations of internal control encompass much more than the numbers on the financial statements.

The audit report does not take exception to the Gordon Administration's engagement of UBS without County Council approval. The audit report states clearly that such approval was not required.

The audit report does not discuss the selection of SIT, West Capital Management, and Fidelity because these transactions happened prior to the timeframe of the audit. However, the conclusion that the UBS contract did not need to be approved by County Council would most likely extend to the SIT, West, and Fidelity contracts. Please note that we did add a bullet to the above comment noting that the Office of Finance did obtain the Clerk of County Council's signature and seal for the use of the custodian of the SIT and West investments, i.e., Fidelity.

Audit Objective: Evaluate whether contracts with the Investment Managers have been reviewed by the Office of Law and whether such contracts reflect best practices.

7. County's Contract with UBS.

Executive Summary

The County executed a contract with UBS which grants a security interest to UBS in all of the assets in the Reserve Accounts held by them. This would have been proper (if ill-advised) had the competitive bid process been followed. It appears that this contract was not formally reviewed by the Office of Law.

Comment

At the beginning of the audit, we looked at the Law Department's Contract Tracking System to try to find information about NCC's contract with UBS for account services. The only UBS contract we could find on Contract Tracking was a consulting contract for UBS to assist NCC in writing a new investment policy.

We then asked the Office of Finance for a copy of the contract for account services, and they provided it. However, since the contract was not on the Contract Tracking system, we questioned whether the Office of Law had reviewed the contract (since this system is used to track various reviews, including Law's, for County contracts).

On May 12, 2014, in a formal memorandum, we asked a First Assistant County Attorney in the Office of Law "Was the contract reviewed by Law before it was executed (as we did not find it on Contract Tracking)? Did Law indeed approve the contract?" (Please note that this was one of three questions we presented to Law in the memorandum.)

In a June 4, 2014 memorandum from the First Assistant County Attorney to the County Auditor, the Office of Law stated "… while the contract did not go through the contract tracking system, the Law Department was involved with … the establishment of the contractual relationship with UBS. As you know, the contract tracking process is not a statutorily required process but rather an internal mechanism to ensure that all relevant departments are advised of a contract before it is executed by the County Executive. In this case, insofar as representatives from Law, Procurement, and Finance were involved in the process, the internal safeguards were satisfied."

In response to this memorandum, the County Auditor sent an email to the First Assistant County Attorney asking "Are you saying in the memorandum that Law reviewed the contract and is satisfied with it from a legal perspective?"

We did not receive a response from Law and, therefore, asked the private law firm to review two issues with the contract:

- Did the grant of a security interest to UBS in all property held by UBS and its affiliates violate any law, ordinance, or regulation? The law firm opined "The grant of a security interest to UBS in all of the assets in the Reserve Accounts under the UBS Account Agreement would have been proper (if ill-advised) had the bid process been followed. (See Appendix G, page 11 for full opinion.)
- Did the entering of an agreement that commits NCC to binding arbitration violate any law, ordinance, or regulation? The law firm opined "It is within the scope of authority of the Chief of Administrative Services to commit the County to binding arbitration." (See Appendix G, page 13 for full opinion.)

Recommendation – Offices of Finance and Law

We recommend that the Office of Law ensure that no contract with an investment manager grants a security interest to the investment manager and its affiliates.

Management's Response - Offices of Finance and Law

The Offices of Finance and Law respect the County Auditor's opinion, but the grant of a "security interest" is a contractual term, part of UBS's standard client Relationship Agreement and other brokerage account opening documents. The very same language was contained in the account opening documents of the previous investment firm, who took over the account without an RFP or formal bid. The Offices of Finance and Law do not reasonably foresee any circumstances under which the County would default on any liability or indebtedness to UBS triggering the sub-section under discussion.

The Office of Finance, managed by the Chief Financial Officer, has the authority to "invest funds deemed by the Chief Financial Officer available for temporary investment in such obligations or in such manner as the County Executive may authorize. NCC Code Section 2.05.503.I. The execution of the UBS Client Relationship Agreement is ancillary to that grant of authority.

Lastly, the County Auditor misunderstands the attorney-client relationship. The Office of Law provides counseling to governmental bodies, including County Council. (Counseling is the practice in which lawyers help clients reach decisions by providing them with legal advice. The client is the ultimate decision-maker.) The Office of Finance may seek counseling and request that the Office of Law review contracts but in no way does the Office of Law "approve" contracts. Contract approval is the purview of the County Executive or his designee and County Council.

County Auditor's Evaluation of Response

We do understand the attorney-client relationship; however, we agree that "approval" is not the appropriate word and have changed the wording in the report comment. When we used the word "approval, we were referring to the step in the Contract Tracking System where the Office of Law indicates that it has reviewed the contract from a legal perspective. Ultimately, as explained in the report comment, the County Auditor asked the First Assistant County Attorney, in an email, "Are you saying in the memorandum that Law reviewed the contract and is satisfied with it from a legal perspective?"

The County Auditor has seen situations where a department has asked language to be changed in a standard vendor agreement, or even asked a vendor to use a County-developed agreement. Therefore, we don't think there was anything hindering the Offices of Law and/or Finance to ask for a change in the wording of the UBS contract.

8. UBS Resolution.

Executive Summary

The County Executive executed a resolution (on a standard UBS form) authorizing the transfer of assets, which resolution indicated approval, by a quorum, of the governing body. However, no such meeting of the governing body was ever held. Although there are no legal consequences of the County Executive signing this form, it would be good business practice to execute a new resolution with UBS.

Comment

When the County opened an account with UBS in January 2013, UBS requested the County to complete a resolution on a standard UBS form titled "Resolution (Association or Other Non-Corporate Organization)." See Appendix H.

The resolution, which includes the names of the CAO and CFO, states:

- That the CAO and CFO are "authorized to sell, assign and endorse for transfer" investment securities registered in the name of NCC Government.

- "Each of the officers listed above hereby certify that the foregoing is a true copy of a resolution duly adopted by the New Castle County Government … at a meeting duly held the 24th day of January 2013, at which a quorum was present and voting …" Please note that the phrase "New Castle County Government" is handwritten on a line printed on the form "Name of Governing Body of the Organization."
- "I certify that the persons listed above are duly elected or appointed qualified officers or authorized representatives of the organization listed above." This statement is signed by the County Executive.

Since the governing body of NCC Government is the County Council, we asked the Clerk of Council whether a meeting was held on January 24, 2013. She told us there was no meeting on that date.

We engaged a law firm to provide legal opinions on various aspects of the procurement of UBS. One of the questions presented to them was "What are the implications, if any, of the County Executive executing a UBS resolution authorizing the transfer of assets, which resolution indicates approval, by a quorum, of the governing body?"

> The law firm opined as follows: "The County Executive was authorized to sign the UBS resolution authoring the transfer of reserve fund assets … we advise you that the execution of the UBS Resolution in its completed from is without legal consequence. However, we are of the view that a corrected version of the UBS Resolution should be executed, reflecting either actual County Council adoption of the resolution or a faithful recitation of the authority by which the County Executive may adopt the resolution." (See Appendix E, page 8 for full opinion.)

Recommendation – Offices of Finance and Law

As stated by the independent law firm, we recommend "…that a corrected version of the UBS Resolution should be executed, reflecting either actual County Council adoption of the resolution or a faithful recitation of the authority by which the County Executive may adopt the resolution."

Management's Response – Offices of Finance and Law

There appears to be no dispute that the County Executive was authorized to sign the resolution with UBS. As noted by the County Auditor's retained counsel, Parkowski, Guerke & Swayze, P.A., any technical flaw in the UBS resolution is without "legal consequence." Although the Office of Law respectfully disagrees with some of the firm's conclusions, this determination is correct. Accordingly, there is no need for a superfluous resolution.

County Auditor's Evaluation of Response

No comment.

Audit Objective: Determine whether NCC's reserve accounts are being administered in accordance with County Code and the edicts from the Korn v. New Castle County lawsuit.

9. Separate Accounts for County Reserve Funds.

Executive Summary

Funds in the various County reserve accounts are not segregated to an adequate degree to make the movement of the assets and funds in and out of those accounts discrete and identifiable. Also, there were two temporary withdrawals from the Tax Stabilization Reserve Account in July 2014 which should have been approved, per Code, by County Council.

Comment

Background

As mentioned on page 2 of the report cover letter, the County has four legislated reserve accounts as follows:

- General Fund Budget Reserve: Budgeted as $33,641,626 for Fiscal Year 2015.
- General Fund Tax Stabilization Reserve: Budgeted as $50,978,906 for Fiscal Year 2015.
- Sewer Fund Budget Reserve: Budgeted as $14,201,372 for Fiscal Year 2015.
- Sewer Rate Stabilization Reserve: Budgeted as $13,855,934 for Fiscal Year 2015.

The total of these four reserve accounts for Fiscal Year 2015 is $112,677,838.

Korn, et. al. v. New Castle County, et. al. Lawsuit (Korn Lawsuit)[19]

The State of Delaware Court of Chancery, in the Korn lawsuit, granted the plaintiff's motion to compel New Castle County (NCC) to provide more complete answers to the plaintiff's first set of interrogatories.

The plaintiff asked, concerning the various reserve/stabilization accounts mentioned in the County Executive's 2004 budget address, for account names and detailed transaction reports. NCC, in both its original and revised responses, stated "… no such discrete account was created or needed to be created. Consistent with the past practice of over 20 years, all of New Castle County's money remains in consolidated cash and/or investment accounts. Such reserves are segregated or designated in the County's audited financial statements."

The Court of Chancery stated "… the account statements provided by defendants to the Court … do not answer the interrogatories. It is impossible to determine from those documents whether

[19] Korn v. New Castle County, C.A. No. 767N, 2005 WL 396341 (Del. Ch. Feb. 10, 2005). See Appendix I for Court's decision.

each of the twelve accounts in question exist, what they are named, when they were created, what balance is in each account, what activity has occurred in each account since its creation … It may be that the funds attributed to the twelve accounts … are commingled in less than twelve bank or investment accounts. If that is the case, there must be some form of accounting ledger that exists to delineate how much of the commingled funds are attributable to each of the twelve accounts and their specific balances …" It should be noted that the 12 accounts mentioned in the court case are now four.

The Korn case was apparently decided without NCC having to provide additional responses to these interrogatories involving separate accounts.

Withdrawals from County Reserves

In July 2014, the CFO initiated two withdrawals from the UBS account, totaling $25,000,000. Although the UBS account does not differentiate between the different types of reserves it contains, the Office of Finance informed us that these funds were withdrawn from the Tax Stabilization Reserve. These withdrawals represented transfers to the County's general operating account to cover cash flow needs. (July is traditionally a slow month for cash receipts because property tax bills are mailed in July and are not due until September 30th.) This has been a common practice and the funds have since been returned to the UBS account. Although we certainly understand the reason for the "temporary" withdrawals, we questioned whether these withdrawals should have been approved by County Council.

County Code Section 14.01.014 states:

> "County Council may by a majority vote appropriate from the Tax Stabilization Reserve Account such sums as may be necessary to balance the annual operating budget or to cover budgeted capital costs that would otherwise require the issuance of bonds or payment of a tax increase."

Legal Opinions

We requested an independent law firm to opine on the following questions:

- In administering the three legislated reserve accounts, must separate accounts be maintained for each of them?

> The law firm opined "… the establishment by the County Council of specific reserve accounts for specific purposes requires, in order not to run afoul of the Court's decision in Korn 1, that the dedicated funds therein must be segregated to an adequate degree to make the movement of the assets and funds in and out of those accounts discrete and identifiable. Mere inclusion in the year-end audited financial statements appears insufficient to allow the tracking of the movement and usage, as they occur, of the funds in the Reserve Accounts." (See Appendix G, page 9 for full opinion.)

- Was approval of the County Council required before the transfer of the funds from the Tax Stabilization Reserve Account to cover a temporary shortfall in the County's operating budget?

  The law firm opined "Approval of the County Council was required before the transfer of funds from the Reserve Accounts to cover the recent shortfall in the County's operating budget." (See Appendix G, page 6 for full opinion.)

Recommendations – Office of Finance

We recommend that the Office of Finance establish a transparent methodology to:

- Identify which institutions house the various reserve accounts and how much of each reserve account each institution holds at any given point in time.
- Ensure an adequate audit trail exists for the movement of funds in and out of the various reserve accounts.

We also recommend that the Office of Finance:

- Obtain Council approval, retroactively, for all of the past temporary withdrawals from the Tax Stabilization Reserve Account (since its creation).
- Ensure County Council approval is obtained for any future withdrawals from any of the reserve accounts.

Management Response – Office of Finance

Procedures concerning the New Castle County reserve accounts were established to conform to the results of the Korn v. New Castle County, et al. case and remain unchanged. Funds are appropriated from the County's treasury through duly adopted ordinances as prescribed in 9 De. C. Section 1152. Reserve Funds are included in the annual fiscal year audit and are described in footnote 18 of the Fiscal Year End Comprehensive Annual Financial Report. Reserve Funds are also referenced in Section 6 of the County's Annual Revenue Ordinance.

Here, the Office of Finance mistakenly stated the July 2014 UBS withdrawals were taken from the Tax Stabilization Reserve Account. The $25 million at issue was taken from unencumbered cash or "available surplus" as proscribed in NCC Code 14.01.008, Balancing annual operating budget. In fact, the FY 2015 Tax Stabilization Reserve Account was not fully funded until after receipt of fall 2014 property taxes. Following the outline of Korn, if all unencumbered cash were automatically appropriated to a reserve account at the beginning of the fiscal year, it would of course become unavailable to balance the budget or meet the County's financial obligations prior to the receipt of the fall property taxes each year, potentially bringing County Government to a grinding halt. The Office of Finance fully funds the General Reserve and Sewer Reserve at the beginning of each fiscal year as prescribed by NCC Code Section 14.01.013.

County Auditor's Evaluation of Response

Management does not address the first set of recommendations regarding establishing a transparent methodology. We disagree that the established procedures comply with the Korn decision.

We do not understand management's response regarding the $25 million withdrawn from the UBS account, as:

- The Office of Finance informed us that UBS manages the reserves, and the $25 million was withdrawn from the UBS account. Also, UBS informed us that it follows the Reserve Fund policy.
- Available surplus is not determined until the end of the fiscal year; therefore, how can a $25 million withdrawal from an account be labeled as coming from available surplus?

The applicable Code Sections are as follows:

> Sec. 14.01.008. - Balancing annual operating budget.
>
> For purposes of balancing the annual operating budget, the term "available surplus" shall be defined as including both those funds remaining on hand from previous years after expenditures for those years have been met and surplus that is anticipated to become available on July 1. If the annual audit shows that there is a shortfall in the surplus, the County Executive shall, within ten (10) working days, present to County Council a proposal that will bring the budget into balance.
>
> Sec. 14.01.014. - Tax Stabilization Reserve Account.
>
> A. There is hereby established a Tax Stabilization Reserve Account within the General Fund.
>
> B. The amount in that reserve account shall be set annually by County Council in conjunction with the adoption of the operating budget.
>
> C. County Council may by a majority vote appropriate from the Tax Stabilization Reserve Account such sums as may be necessary to balance the annual operating budget or to cover budgeted capital costs that would otherwise require the issuance of bonds or payment of a tax increase.

Audit Objective: Evaluate financial statement footnotes and the official statements from the latest County bond issuance to determine whether they properly represent the County's investments and investment policies.

10. Investment Information Contained in Public Documents.

Executive Summary

We noted two items regarding Footnote #2 ("Deposits and Investments") in the County's financial statements for Fiscal Years 2010, 2011, and 2012.

- Information regarding the County's ability to invest in non-money-market mutual funds was omitted from this footnote in the subheading "Credit Risk." This is somewhat mitigated by the fact that the information was included in Footnote #1 ("Summary of Significant Accounting Policies").
- The non-money-market mutual funds (approximately $46 million in value when they were sold in early 2013) were listed in the footnote's Schedule of Investments as "Money Market Mutual Funds (included in Cash Deposits.)" This may have been a material misrepresentation in those years.

Regarding the first item above, a similar omission was made in the County's Official Statements for the 2010 and 2012 bond issuances. However, the Financial Advisor for the County's recent bond issuance informed us that his firm does not consider this to be material.

Comment

Notes to County Financial Statements

The County Executive and CAO made us aware, during the course of the audit, of an issue in the County's audited financial statements for Fiscal Years 2010, 2011, and 2012. That is, NCC entered into an agreement with a prior investment manager to have such manager invest a portion of the County's reserve funds in non-money-market mutual funds; however, Footnote #2 in the financial statements, titled "Deposits and Investments", did not include in the subheading "Credit Risk" the fact that NCC was invested in such mutual funds. This footnote reads:

> "Authority and responsibility for managing the investment program is granted to the Chief Financial Officer via the County Executive, and is derived from Delaware Code, Title 9, Chapter 13. Per the County's investment policy, the County's allowable investments are …" The footnote then lists the allowable investments per the County's investment policy(ies). The footnote does list "Money market funds regulated by the Securities and Exchange Commission and whose portfolios consist only of dollar-denominated securities." However, the mutual funds invested in by the investment manager were not "money market mutual funds" [i.e., funds required to maintain a net asset value (NAV) of $1.00].

We discussed this situation with the Office of Finance which acknowledged that Footnote #2 should have listed mutual funds as an allowable investment. However, Finance informed us that Footnote #1, titled "Summary of Significant Accounting Policies", does list mutual funds as an allowable investment under the subheading "Deposits and Investments."

We analyzed Footnote #2 further and determined that the applicable mutual funds (approximately $46 million in value when they were sold in early 2013) were listed in the Schedule of Investments as "Money Market Mutual Funds (included in Cash Deposits)." As indicated above, the applicable mutual funds were not money market mutual funds. Since there is a separate line in the Schedule of Investments called "Mutual Funds", we questioned why the applicable mutual funds were not included on that line.

We spoke to the current external auditors for NCC's financial statements who confirmed that the applicable mutual funds should have been included on the "Mutual Funds" line and, also, that they should not have been classified as Cash Deposits in the financial statements. Since the value of these mutual funds was approximately $45 million as of June 30, 2012, the current external auditors (who were not the auditors for Fiscal Years 2010 through 2012) told us that this may have been a material misrepresentation; however, they do not want to opine on what a prior external auditor may (or may not) have considered a material misrepresentation.

The current external auditors thought the omission, in Footnote #2, of mutual funds as an allowable investment was not a major concern because this information is included in Footnote #1.

Official Statements for 2010 and 2012 County Bond Issuances

The County Executive and CAO made us aware, during the course of the audit, of an issue in the County's Official Statements (OS) for bond issuances in calendar years 2010 and 2012. That is, NCC entered into an agreement with a prior investment manager in 2010 to have such manager invest a portion of the County's reserve funds in non-money-market mutual funds; however, under the heading "Cash Management System" (where the County listed the non-pension investments the County may invest in), no mention was made of such funds. The footnote does list "money market mutual funds regulated by the Securities and Exchange Commission and whose portfolios consist only of dollar-denominated securities"; however, the applicable mutual funds were not "money market mutual funds" [i.e., funds required to maintain a net asset value (NAV) of $1.00].

We discussed this situation with the Office of Finance which acknowledged that the OS should have included non-money-market mutual funds as an allowable investment. However, Finance informed us that:

- Footnote #1, titled "Summary of Significant Accounting Policies", does list such mutual funds as an allowable investment for the years encompassing the bond issuances.
- The County's Comprehensive Annual Budget Summary (CABS) for both years also listed mutual funds as an allowable investment, i.e., "for portfolios that invest primarily in mutual funds, the County currently limits its investments to open-ended 1940 Act mutual funds."

We spoke to the Financial Advisor (FA) for the County's recent bond issuance. This individual informed us that the omission of non-money-market mutual funds from the 2010 and 2012 official statements is not considered to be a "materially inaccurate statement" per the MCDC (Municipalities Continuing Disclosure Cooperation Initiative) released by the SEC's Division of Enforcement in March 2014.[20]

Recommendation – Office of Finance

We recommend that the Office of Finance speak to the FA for the recent bond issuance and ask whether the issue of non-money-market mutual funds being listed as money market mutual funds in the 2010 – 2012 audited financial statements should be disclosed in any manner.

Management Response – Office of Finance

The Office of Finance notes the immaterial errors in the County's recent financial statements occurred under prior administrations. The Gordon Administration discovered that the Comprehensive Annual Financial Reports (2010 and 2012) and Official Statements (2010 and 2012) misrepresented the County's credit risk. These errors occurred during the tenure of the

[20] Such initiative allows "favorable settlement terms to issuers and obligated persons involved in the offer or sale of municipal securities … as well as underwriters of such offerings if they self-report to the Division possible violations concerning materially inaccurate statements relating to prior compliance with the continuing disclosure obligations specified in Rule 15c2-12 under the Securities Exchange Act of 1934." The deadline for municipalities to report was December 1, 2014.

County Auditor. Per State Code, "Certification of Annual Financial Report" is among the statutory duties required of the County Auditor.

The County's Financial Advisor assisted the County with its self-assessment of compliance with its continuing disclosure responsibilities. If the Office of Law and the County's bond counsel determine supplemental disclosures are appropriate, such steps will be taken.

County Auditor's Evaluation of Response

The Office of Finance is misleading when it states "Per State Code, 'Certification of Annual Financial Report' is among the statutory duties required of the County Auditor." The relevant State Code Section states:

> § 1403 Certification of annual financial report of Chief Financial Officer.
>
> (a) The County Auditor shall have a qualified accounting firm conduct an audit of the annual financial report of the Chief Financial Officer and append thereto a certificate which shall state whether, in the opinion of the accounting firm, the financial statements in the financial report:
>
> (1) Contain a proper record of the County's financial transactions for the year;
>
> (2) Properly reflect the current assets, liabilities, and funded debt of the County as of the close of the fiscal year; and
>
> (3) Comply with generally accepted principals of governmental accounting.

The County Auditor is responsible for engaging a firm to conduct the audit and such firm (not the County Auditor) provides the certification (i.e., audit opinion). The Office of Finance does not even provide the CAFR (Comprehensive Annual Financial Report) to the County Auditor until the day the final CAFR is presented to the County Executive and CAO. Perhaps if the Office of Finance provided the County Auditor with a draft CAFR to review, the County Auditor could review the footnotes and other materials and provide feedback.

Regarding supplemental disclosures, have the Office of Law and the County's bond counsel determined whether such disclosures are appropriate?

Audit Objective: Evaluate internal controls over various aspects of the investment process.

11. Investment Board

Executive Summary

County Council should consider establishing an Investment Board to oversee the management of the County's investments, similar to the State of Delaware's Cash Management Policy Board which oversees the State's investments.

Comment

We believe many of the comments in this report are indicative of the need for an Investment Board, composed of employees as well as people outside the government with a strong knowledge of investments.

We support the establishment of such a board for the following reasons:

- As indicated in our General Comment on page 9, the level of the County's reserve funds are an important element in bond rating agencies assessing the strength of the County's financial condition; therefore, it makes sense to have a strong independent body oversee them.
- To ensure the County's investment portfolio is overseen by people with knowledge and expertise in the field.
- The State of Delaware has such a board, called the Cash Management Policy Board, for its own investment portfolio. It has done well in protecting the State's investment portfolio.
- The Pension Board works well in overseeing the Pension funds for NCC employees and retirees. We believe that the same concept should be extended to other County funds.
- When Administrations change, the existence of an Investment Board would help to alleviate transition risk.

A County Council Member introduced an ordinance on August 26, 2014 to create such a Board, called the New Castle County Investment Advisory Board. This Council Member decided to "table" the ordinance until the issuance of this audit report. Per the ordinance,

> "The purpose of the New Castle County Investment Advisory Board is to establish policies for the investment of money belonging to New Castle County (except for money invested in a pension program or deferred compensation program), to make recommendations regarding the terms, conditions and other matters relating to those investments, to recommend changes in law to effectuate those policies, terms, conditions, and other matters and best practices for investment matters, to evaluate the performance of selected Investment Managers, and to provide advice to New Castle County Council, the County Executive and the Office of Finance on all other matters regarding County investment management."

The ordinance provides for the Board to consist of nine members: The CFO, the Treasury Manager, four residents of New Castle County appointed by New Castle County Council, and three residents of New Castle County appointed by the Chief Executive. We do not believe the Board needs nine members to be effective and think Council should consider having either five or seven members.

Recommendation – County Council

We recommend that County Council strongly consider the creation of an Investment Board and consider a membership number of either five or seven members.

Management Response – County Council

County Council did not provide a formal response. However, as indicated in the comment, a Council Member has drafted legislation to create an Investment Board.

12. Review of Draft Reserves Policy.

Executive Summary

We have reviewed the Government Finance Officers Association's (GFOA's) "Financial Policies" publication's chapter on investment policies, the GFOA's Best Practices document titled "Creating an Investment Policy"[21], and the draft "Reserves" policy written by UBS. We are providing suggestions to management for enhancements to this policy.

Comment

New Castle County (NCC) Code Section 2.05.503 states "The Office of Finance, managed by the Chief Financial Officer … may perform the following functions …

I. Invest funds deemed by the Chief Financial Officer available for temporary investment in such obligations or in such manner as the County Executive may authorize." (Note: This same language is in Delaware State Code, Title 9, Section 1371.)

The Office of Finance engaged UBS to write a new investment policy for the County's reserves. (See Appendix B.) On September 23rd, 2014, County Council passed a resolution requesting "… the members of the New Castle County Financial Advisory Council utilize their professional expertise to review New Castle County's current investment policies and provide recommendations to improve or clarify current practices."

[21] This document states "A written investment policy is the single most important element in a public funds investment program."

We have reviewed the Government Finance Officers Association's (GFOA's) "Financial Policies" publication's chapter on investment policies, the GFOA's Best Practices document titled "Creating an Investment Policy", and the draft "Reserves" policy written by UBS. We are providing suggestions to management and to NCCFAC for enhancements to this policy. See Appendix J.

Recommendations – NCCFAC and Office of Finance

We recommend that NCCFAC and the Office of Finance:
- Take our comments/questions into consideration in their review of the Reserve Fund policy.
- Consider consulting with the State of Delaware's Cash Management Policy Board on their policy and how it was developed.

Management Response – Office of Finance

The Office of Finance currently plans to review all investment policies with the assistance of the County's new investment managers.

County Auditor's Evaluation of Response

The response does not provide a target date by which this review will occur.

13. Periodic Reporting to Council of Investment Portfolio Performance.

Executive Summary

Management should periodically meet with County Council in a public meeting to review the investment performance of the County's investment portfolio.

Comment

The Office of Finance has not made it a standard practice to report periodically to Council on the performance of the County's investment portfolio. A prior investment consultant, which was engaged through early 2013, met with the Office of Finance quarterly and covered the performance of the County's outside investment managers in achieving the applicable investment policies' performance objectives. Although the County no longer employs a consultant to oversee the performance of the investment managers, it is our understanding that the Office of Finance does occasionally have meetings with the investment managers themselves.

Recommendations

We believe it would be a good practice for the Office of Finance, at a County Council Finance Committee Meeting, to provide periodic (e.g., quarterly) presentations on the performance of the

County's investment portfolio. We recommend that the Office of Finance work with the Finance Committee Co-Chairs to schedule such periodic presentations.

Management Response – Office of Finance

The Office of Finance makes regular reports to County Council concerning the County's accounts, books, and records. The Office of Finance will communicate with Council's Finance Committee to determine additional needs, if any.

County Auditor's Evaluation of Response

The County CFO, at a County Council Finance Committee meeting on September 29, 2015, informed Council that the County's new Investment Advisor will make quarterly reports to Council on the performance of the County's investment portfolio.

Appendix J

We have reviewed the Government Finance Officers Association's (GFOA's) "Financial Policies" publication's chapter on investment policies, the GFOA's Best Practices document titled "Creating an Investment Policy", and the draft policy written by UBS. (See Appendix B.) We have several items which we believe the Administration and the New Castle County Financial Advisory Council (NCCFAC) should consider in evaluating this policy. These items will be provided to the New Castle County Financial Advisory Council (NCCFAC) and are as follows:

- Should the policy contain the language in the State and County Codes on the authority of the CFO to invest funds as the County Executive may authorize?
- General: It appears that there is duplication in certain sections and that the policy could be shortened if management takes a closer look at this.
- If County Council votes to create an Investment Board, management should include information about the Board in the policy. Also, we believe that County Council should be asked to review and approve the new policy.
- Before NCCFAC reviews and comments upon the policy, the County Administration should meet with NCCFAC to explain the County's risk tolerance for its reserves as well as its general investment strategy.
- Scope: Management should include information about the different County reserve funds and decide whether there should be different risk tolerances for the "rainy day" funds (which are not as likely to be accessed) versus the other reserve funds. Also, if management's policy is to pool the different reserve funds for investment management purposes, , this should be mentioned.
- Page 5 of draft policy: The "Primary Investment Objective" is listed as "Current Income." Typically the objectives of a government's investment activities are, in order of importance, safety (i.e., the preservation of capital and the protection of investment principal), liquidity, and income. Management should determine whether current income is indeed the primary objective.
- Page 5 of draft policy: We think it would be helpful to define "Portfolio Time Horizon."
- Page 6 of draft policy: "The County Administrator and the CTC involved with the investment process shall refrain from personal business activity that could conflict with the proper execution of the investment program …" The policy defines "CTC" but does not define "County Administrator." This should be defined. Also, should the policy include any details on the disclosures to be made by members of the CTC?
- Page 6 of draft policy: "Risk will be measured by the standard deviation of quarterly returns." Who will be doing this and who will the information be reported to? Also, will there be a benchmark against which to measure the portfolios' measurement?
- Page 7 of draft policy: Will the CTC be reporting investment performance to other parties (e.g., County Executive, CAO, Council)? Also, how often will the CTC be evaluating performance?
- Page 8 of draft policy, Custodian: Should we be asking the custodian for a SSAE No. 16 report (i.e., the annual service organization report on the internal controls of the custodian)?

- Page 8 of draft policy, Policy Review: “Monitored rules will be reviewed quarterly, and presented by the CTC member assigned …” Will there be a written report of this review? Will this be presented to anyone other than the CTC (e.g., County Executive, CAO, Council)?
- Page 9 of draft policy: Does management want to include anything on its maturities policy (e.g., average weighted maturity of portfolio, maximum maturity of any given investment)?
- Page 10 of draft policy, Professional Management: There should be something in here about the CTC putting this out for competitive proposals.
- Page 10 of policy, Operating Guidelines: Does the CTC possess the tools/expertise to be able to do “financial simulation models”? Isn’t this something the investment managers should be doing for us?
- Authorized Investments: Should there be a separate section on these? We know they are also in the asset allocation section on page 12, but perhaps they could be listed elsewhere with detailed definitions.
- Page 12 of draft policy, Asset Allocation: “… any security downgraded to a non-investment grade must be sold immediately, unless approval is gained to hold.” Is this part of the CTC’s quarterly review of rules compliance or is this something the investment managers will be doing daily? Management may want to specify this.
- Page 12 of draft policy, Benchmarks: What is meant by “as appropriate”?
- Page 12 of draft policy: If the portfolio may invest in certificates of deposit or repurchase agreements, should there be something in the policy about collateralization requirements?

APPENDIX K

Please note that any evaluation of an investment manager needs to encompass an evaluation of the fees being paid versus the investment performance being achieved. Also, any evaluation of investment performance has to be done against the relevant performance benchmarks.

The following pages provide performance reports for the portfolios managed by two prior investment managers (the ones terminated in 2013, which we call Manager A and Manager B here), Wilmington Trust (WTC), and UBS. Please note that we do not opine on the adequacy/relevancy of the benchmarks; we are merely providing the information.[22] A summary of such information is as follows:

- **Manager A:** From the period December 31, 1995 (the inception of the account) through September 30, 2012, the portfolio earned a time weighted rate of return (net of fees) of 5.99% versus the two benchmarks in the applicable investment policy: CPI (Consumer Price Index) +1.5% = 3.98%, 90% of the BCGCI (Barclays Capital Intermediate Government/Credit Index) = 5.10%. Thus, the portfolio's rate of return exceeded both benchmarks. .

- **Manager B:** For the period March 4, 2010 (the inception of the account) through December 31, 2012, the portfolio earned a time weighted rate of return (net of fees) of 1.83% versus the Bank of America Merrill Lynch One Year Treasury Bill Index of 0.42%. The standard deviation of monthly returns during this timeframe was 0.55%. Per the investment policy agreement with Manager B, "the goal is to invest the assets for a period of one year or more and to generate an annualized rate of return that exceeds the rate of return from investing in the risk-free asset, the 360 day US Treasury Bill, while maintaining liquidity and a level of volatility lower than 3% as measured by annualized standard deviation of monthly returns."

- **WTC:** Since being engaged by the County in 1999, WTC has earned a time weighted rate of return (net of fees) of 5.11 versus the performance benchmark (90% of the Lehman Intermediate Government/Credit Index) of 4.26%.

- **UBS:** We reviewed UBS's investment performance for the period February 7, 2013 (the inception of the account) through November 21, 2014. The net time weighted rate of return for this period was 0.43% per a performance review report provided to us by UBS. The benchmarks[23] in the May 15, 2014 "Reserve Fund" policy (which is what UBS informed us they are following) and the net time weighted rate of return for those benchmarks, as listed in the performance review report, are as follows:
  - Barclays Gov./Credit 1-3 years: .83%
  - Barclays Gov./Credit 1-5 years: 1.00%

[22] Also, since UBS has been managing the account during a period of historically low interest rates, one should not compare their investment performance against investment managers who have been managing investments for the County for a longer period.

[23] The policy lists the benchmarks "as appropriate." We do not know which one management has specified for UBS to follow.

- Barclays Int. Gov./Credit: Percentage not listed in report.
- Barclays Aggregate: 2.08%

The actual net time weighted rate of return of .43% does not exceed any of these benchmarks. The Barclays Gov./Credit 1-3 years benchmark appears to be the most relevant benchmark since the strategy of UBS has been to reduce the average maturity of the fixed income investments in the portfolio. As of November 21, 2014, the average effective maturity in the portfolio is 1.56 years, with 69.2% of investments maturing in 2015 and 19.7% maturing in 2016.

The report also provides the following two benchmarks that are <u>not</u> included in the "Reserve Fund" policy.

- Barclays US Sh. Treasury (9-12 months): .24%
- US Treasury Bill – 3 months: .04%

The actual net time weighted rate of return of .43% exceeds both of these benchmarks. We are not sure if these are the relevant benchmarks to be using since the average effective maturity in the portfolio is 1.56 years. (However, the average modified duration is .76 years.) If these are indeed the relevant benchmarks, then these should be specified in an Office of Finance investment policy.

Note: UBS informed us that, in restructuring the investment portfolio, many securities were sold which had premiums (i.e., were bought for higher than 100); such premiums had to be fully amortized upon sale which negatively affected the net time weighted return for this period. The Office of Finance should explain this to County Council.

Note: UBS's net time-weighted rate of return for the period January 1, 2014 through November 21, 2014 was 1.12. A review of the performance of the State of Delaware's reserve funds from January 1, 2014 through November 30, 2014 revealed that the average net time-weighted rate of return for this time period (for five investment managers) was 1.77%. However, we did not research what the State's risk tolerance level is for its reserve funds.